

Introduction

This section of the Handbook provides general guidance for conducting and controlling compliance examinations. Effective control expedites and enhances the examination process by ensuring that objectives are met efficiently.

The first step toward initiating an examination, the setting of scope, was discussed in Section 110 of this chapter. This section proceeds on the premise that the type of examination to be conducted has been identified (see Section 105) and the initial scope has been established. This section also proceeds on the premise that a “regular” examination is being conducted. If a “targeted” or “special” examination is scheduled, the process described here may be abbreviated as appropriate.

Before reading further in this section, the examiner should be familiar with the discussion of the “top-down/risk-focused” approach presented in Section 105 of this Handbook chapter.

The section discusses:

- Procedures Upon Arrival
- Controlling the Examination
- Analysis of the Compliance Management Function
- Review of Regulatory Areas
- Appendix A: Compliance Management Questionnaires
- Appendix B: External Interviews
- Appendix C: Sampling Techniques
 - Judgmental
 - Nondiscrimination
 - Branch Systems

Procedures Upon Arrival

Upon arrival at the association, the examiner-in-charge (“EIC”) should meet with senior management, generally including the CEO, and the compliance officer to discuss the anticipated scope and administration of the examination. One objective of this meeting is to summarize for management the current OTS approach to compliance examinations. Other topics that may be discussed, which bear on the course of the examination, include:

- Changes in control, board of directors or management;
- Changes in organizational structure or business strategies;
- Changes and events in the local economy and the community; and
- New products just introduced or being readied for introduction.

If not received previously, the EIC should request an organization chart or list of the officers in charge of the various departments and branches in which the examiner will be working and of any other key individuals recommended by management. Other administrative matters that might be discussed include:

- The names of examiners and designation of the EIC as the contact for any problems staff or management may encounter with the examination process;
- Any particular equipment or support needs anticipated (e.g., unrestricted telephone line, photocopier, etc.);
- Importance of staff cooperation in responding to requests for information and documents; and
- Availability of examiners to answer questions from staff regarding requested information or about compliance matters generally.

The examiner should obtain any forms, policy statements, procedures manuals and other docu-

ments that were submitted by the association prior to the on-site examination.

Controlling the Examination

Controlling the examination is an important responsibility of the EIC. The level of control required will depend on the activities to be performed, the size and experience level of the examination team and the size and nature of the institution. Several key elements of control are addressed in the following paragraphs.

Establishing Objectives

Establishing clear objectives and a methodology for the team members to follow is crucial. The EIC must ensure that assistants understand the objectives for the examination as a whole and for the specific parts assigned to them. Objectives should be specific, measurable and achievable with available resources within the required time frames.

The examination procedures contained in the individual Handbook sections are designed to be comprehensive. It is important that only appropriate procedures be selected with respect to each compliance matter under review. Assisting examiners should notify the EIC as questions regarding scope or depth of review occur. The EIC should assist examiners in understanding the initial scope of procedures for each compliance area and in determining when expansion is required.

Organization

Organization involves scheduling meetings with institution personnel; arranging workspace; prioritizing and scheduling assignments and work flow; communicating examination status; reviewing, organizing and indexing workpapers; preparing the report of examination; and concluding the examination according to OTS procedures. Effective control of the examination requires that the EIC anticipate, plan and conduct each of these activities as an integrated part of the overall process.

Assignments and Monitoring

The EIC must determine the expertise necessary to perform certain aspects of the examination and make assignments accordingly. To the extent feasible, examination procedures requiring access to the same documentation should be assigned to the same examiner in order to avoid duplicative file searches.

Each assistant's performance must be monitored throughout the process to ensure that objectives are met, schedules maintained and problems recognized and resolved. Early identification of problems allows assistants to correct mistakes and improve skills without harm to the examination product. Monitoring also allows for necessary adjustments to scope where noncompliance is identified, but minimizes unnecessary diversions from the planned examination program.

Time Management

It is important that the examination be conducted in as short a period as is practical. When making assignments, the EIC should estimate the time necessary to complete each portion of the examination. Actual time should be tracked against initial estimates as a means to identify scheduling problems as early as possible. If a material departure from the initial estimate of examination time is foreseen, this should be discussed by the EIC with a supervisor immediately.

Training and Evaluation

On the job training and evaluation of assistants is an essential responsibility of the EIC. Trainee or assistant examiners may frequently need guidance, depending on their training, experience and ability. Assignments should be given with ample instructions. Feedback and questions should be encouraged. The EIC or another experienced examiner should be available for guidance and to review the work of a trainee assistant. However, the EIC will generally be responsible for the official evaluation of the assistant's performance at the conclusion of the examination.

Analysis of the Compliance Management Function

Once the examination team has taken care of routine logistical matters, the primary focus should be on performing an analysis of the association's compliance management function. The EIC should arrange meetings with the Compliance Officer, appropriate Senior Management and the Internal Auditor (if the internal audit includes compliance matters).

The purpose of these meetings is to gain a thorough understanding of how management approaches its compliance responsibilities and to determine how well management has integrated compliance into its daily operations. These meetings should probe into areas such as the compliance knowledge of these individuals (fully recognizing that senior management will not have as detailed a knowledge of regulatory requirements as the compliance officer), the internal systems of the association, available training programs and attendance, the extent of internal reviews and their findings, the involvement of the compliance function in new product development, steps taken to correct previously cited deficiencies and CRA activities.

Appendix A to this section contains questionnaires that can be used to guide these discussions. The examiner should adapt these questionnaires to the circumstances at each association and in response to the findings of the pre-exam analysis. Under no circumstances should the questionnaires be given to management to complete. These should be face-to-face discussions held at the very beginning of the on-site portion of the examination, prior to any sampling or transaction-testing. The results of the interviews will help the examiner further refine their scope and determine the extent to which individual laws and regulations and particular aspects of those laws, need be reviewed. For example, the questionnaire for the compliance officer asks many regulation specific questions. Poor, incomplete or hedged answers to a particular question should flag for the examiner the need to do some review of that regulatory subject.

These discussions, taken together with the pre-examination analysis, constitute a major portion of

the compliance examination process and form the foundation for the review of regulatory areas. Done properly, this analysis and interview process should substantially reduce the amount of effort that needs to be devoted to reviewing transactions. It should be clear from these first two parts of the examination process whether management has taken a proactive approach to compliance and can demonstrate its abilities to assure compliance.

During this part of the examination process, the examiner should also conduct community contact interviews for CRA purposes. Suggestions for conducting these external interviews are contained in Appendix B to this section.

Review of Regulatory Areas

As mentioned in Section 105, all laws and regulations within the purview of the Specialized Compliance Examination Program fall into two main groupings for purposes of this stage—a Core Group and a Sensitivity-Based Selection Group. The Core Group includes laws and regulations that involve high-risk, high-profile issues and matters of great sensitivity to the public and to this agency. The Sensitivity-Based Selection Group includes all other laws and regulations.

Core Group

The Core Group consists of the following:

Fair Lending

- 12 CFR 528 - Nondiscrimination
- Regulation B (discrimination issues only)
- Fair Housing Act
- Home Mortgage Disclosure Act

Community Reinvestment Act

Regulation Z (calculation aspects only)

OTS Mortgage Regulations (notifications and accuracy of adjustments only)

Bank Secrecy Act

All applicable examination procedures pertaining to those aspects of the laws and regulations in the

Core Group are to be performed at each regular compliance examination. As a general rule, judgmental sampling should be used to carry out the procedures. Statistical sampling can be used but only in extraordinary circumstances. Appendix C contains information on sampling techniques.

The examiner should notice only certain aspects of Regulations B and Z and the OTS Mortgage Regulations fall into this Core Group. That is not to say that all other aspects are eliminated from review—the remaining aspects of those regulations fall into the Sensitivity-Based Selection Group. The Regulation B review performed as part of this Core Group analysis should focus on those procedures relating to discrimination on prohibited bases, prescreening, discouraging applications, and imposing liability on nonapplicant spouses. The Regulation Z review performed as part of this Core Group analysis should focus on those procedures relating to the calculation of Annual Percentage Rates, use of a composite APR in discounted variable rate mortgage transactions, finance charges, amount financed, and payment schedules, as well as the treatment of mortgage insurance, credit life insurance and prepaid finance charges. The review of ARM products should focus on the accuracy and timing of the adjustment notifications and the actual adjustments.

Sensitivity-Based Selection Group

All remaining laws and regulations fall into this second grouping. The selection of laws and regulations for review is based on the association's history of compliance, the degree to which the examiner has reason to believe there may be weaknesses in a given area, the length of time since a particular law or regulation has been included in the scope of a compliance examination, areas where the association has had problems in the past, areas where other similar associations have experienced problems, areas where there is a current public interest, and new or substantially changed laws or regulations, or new product offerings since the previous examination.

For example:

- if the examiner is aware that there has been a large percentage of consumer complaints re-

garding the handling of escrow accounts, the examiner would include escrow accounts in the review and follow the examination procedures for escrow accounts in the RESPA section of this handbook.

- if the examiner determines that the association began offering home equity lines of credit since the previous examination, a judgmental sampling of that product should be selected for review. The examiner might want to focus on the Truth in Lending Examination Procedures for Open End Credit numbers 11 - 19.
- if the examiner sees that the association's flood hazard insurance procedures are insufficient to assure that flood insurance notices are made, then a review to determine that insurance is maintained on covered properties would be in order. The examiner should look to the Flood Insurance Examination Procedures and select procedure 1 under "Notice Requirements."
- if the examiner determines that the association has recently reviewed its adverse action notifications and has found substantive problems, a review of these notifications would be in order to assure that any corrective remedy is properly working. Regulation B Examination Procedure numbers 2 and 3 would provide guidance here.
- if the examiner is aware that local financial institutions are not adhering to the funds availability requirements for nonlocal checks, then a judgmental review of the association's adherence to the regulatory standard should be undertaken. The examiner should perform the Expedited Funds Availability Act Examination Procedures for time frames for local checks.
- if the examiner observes that no aspect of the Fair Credit Reporting Act was reviewed on-site during the previous compliance examination, then the examiner should select some aspect of that law for inclusion in this particular examination. In this instance, the examiner might want to determine that the association, as a user of information from a consumer reporting agency is making the required disclosures.

Not all laws and regulations will be included in this review at every examination. Moreover, complete reviews of all regulatory requirements for these laws and regulations will be the rare case—the focus is on various aspects of those laws and regulations selected depending upon certain criteria and current interest. In no event, however, should two consecutive regular compliance examinations take place where a particular law, and at least some aspect of it, is omitted from the scope of the on-site portion of the examination. The Washington office will issue periodic advisories concerning aspects of laws and regulations that are posing compliance difficulties for associations or that are receiving an intense degree of public scrutiny to aid in this selection process. The Regional offices are strongly encouraged to assure inclusion of localized concerns in compliance examinations, as well. These areas will change over time and the examiner should exercise good judgment in this selection process by focusing on “risk-prone” issues.

Above all, the examiner should not view the laws and regulations that fall into this grouping as discretionary or optional items. The purpose is to afford the examiner the flexibility to focus on important areas and to minimize the time spent on areas where the compliance systems of the association appear strong and where the likelihood of problems or noncompliance is extremely small.

To some measure, the extent of this review will turn on the degree to which the association’s Compliance Officer has performed. When the examiner is confident that the work of the Compliance Officer is thorough and effective, that the Compliance Officer has been delegated the requisite authority by the Board of Directors to effectuate corrective actions, and that the compliance track record proves this, the examiner’s degree of sampling and review is correspondingly reduced. On the other hand, inadequate attention by the Compliance Officer to critical areas, or a lack of follow-up in general means that the examiner will have to exercise much discretion in determining those aspects of particular laws that will be reviewed.

Compliance Management Questionnaires

Senior Management Questionnaire

The EIC should describe what he/she knows about the association's business strategy and ask management for further elaboration.

Describe your approach to managing the compliance function.

What percentage of the resources under your control are devoted to compliance?

How do you stay abreast of changes in laws?

How do you assure that your staff stays abreast of changes in laws?

How often do you review your geographic lending distribution?

Have you had any compliance training?

How do you assure that compliance is considered as part of new product development, marketing and advertising?

How are you involved in community outreach? How do you encourage your staff to be involved with the community and bring back concerns and suggestions?

Describe your marketing strategy.

Do you make any periodic reports to the Board of Directors on your CRA and compliance efforts?

Would you describe your Board's participation in CRA and compliance matters as active or passive?

What is your most typical consumer complaint?

What is your view of the role of your compliance officer in this organization?

What role does the internal audit department play in managing compliance responsibilities?

Compliance Officer Questionnaire

What is the biggest compliance problem that you have worked on during the past year? Would you describe this as a typical or unusual situation, in relation to how your compliance program works?

What is the main complaint that your customers have? Are there any areas in which compliance with federal rules causes more confusion than understanding?

Do you have any other responsibilities at this association? What percentage of your time are you able to devote to compliance? Do you think that this is adequate? Should more time be spent on compliance? Is more staff needed?

Describe where you believe your compliance responsibility fits within the management structure at this association.

Do you get adequate support on your compliance program from your superiors?

We sometimes see that department managers would like to correct compliance problems quietly, without calling attention to them. In other cases, employees are told to keep quiet about compliance problems. How are employees and their managers encouraged to come forward with compliance problems and questions?

Describe your compliance experience. Where did you get your training? Do you attend any periodic compliance seminars? If so, which ones and when?

How do you keep abreast of changes in laws and regulations? How do you communicate those changes to key personnel within the association? What kinds of compliance publications do you subscribe to, if any?

What kind of compliance training programs have you put in place, particularly for lending officers and account personnel? How did you narrow down the material and the list of those to attend? Do you see an immediate need for staff training that you have not yet been able to arrange for?

How involved is either your in-house or outside counsel with compliance matters? Do they review forms, disclosures, notes, agreements, policies, etc.?

Do you work with the marketing and product development staff on new product initiatives to assure that compliance issues are being considered? Are there any programs or promotions that have been developed during the past year which you found out about after-the-fact?

Does a comprehensive self-assessment, or more of an audit-program approach seem to make more sense for this association? What is the flow of the written reports of your reviews?

How often do you determine that your policies and procedures in the following areas are current and consistent with law and regulation?

- lending
- training programs
- consumer complaints
- advertising and promotions
- branch administration and office procedures

How do you determine whether any changes in automated systems will adversely affect disclosures?

How much of your compliance review work involves testing actual transactions? In which areas do you draw your largest samples? How do you select your samples? Are there areas of compliance in which performance is considered to be so strong, or the consequences of noncompliance so minimal that no sampling is done?

How do you get your association to correct deficiencies uncovered during your reviews?

How do you verify that:

- applicants are not being discouraged from applying for credit?
- applicants are able to receive credit in their own names (without a spousal signature)?
- credit histories are maintained properly?
- applicants receive timely and accurate adverse action notices?

Have you found a way to stress with lending staff and officers, the importance of nondiscrimination in lending? Has the board of directors communicated any particular interest in having a nondiscrimination review conducted?

As part of the PERK, we asked for information on any geographic distribution analysis of loans and applications that you may have conducted. Exactly how did you do your last review? What did you conclude from it? Were any changes made as a result?

How do you assure that the loan application registers are being completed properly?

How do you determine that:

- TIL disclosures are accurate and given on time?
- APRs and FCs are correctly calculated?
- Rescission rules are being adhered to?

Do you pay particular attention to discounted ARMs in your reviews? Loans with PMI? Loans with other mortgage guarantee insurance?

How do you assure that ARMs are being adjusted properly, and that ARM notifications are accurate and timely?

How do you determine whether a property serving as collateral for a loan is in a special flood hazard area? How do you assure that flood insurance is maintained during the life of the loan?

How do you make sure that RESPA's requirements are being adhered to? Did you have any problems complying with the recent servicing and transfer and escrow rules?

Do you have any EFT activity? If so, how do you determine that:

- access devices are issued properly?
- consumers are furnished adequate initial disclosures?
- error resolution procedures are followed properly?
- records are maintained properly?

Explain your check-hold policies under the Expedited Funds Availability Act. Do you test periodically to assure adherence to any time frames?

Do you receive requests from the Federal government for financial information on your customers? If so, how do you determine that the financial information is released consistent with the Right to Financial Privacy Act?

Does your association collect debts in other than its own name? If yes, describe how you comply with the notice requirements and prohibitions in the Fair Debt Collection Practices Act.

Describe your BSA compliance program. What kinds of periodic reporting do you do? Do you review CTRs for completeness and accuracy? Do you make sure that the forms are filed with the IRS? What kind of analysis do you do to assure that there is no money laundering activity going on in your association? Do you have a system to aggregate multiple transactions?

As part of the PERK, we asked you for copies of recent advertisements. How do you ensure that your advertisements are in compliance with rules?

Do you believe that there are any particular weaknesses in your compliance activities?

Internal Auditor Questionnaire

Describe your reporting relationship within the association.

Do you include compliance matters in your internal audits?

If “no,” stop here.

If “yes,” then ask the following:

Have you had any compliance training?

How do you keep on top of changes to laws and regulations?

Are your audits conducted pursuant to a set schedule? Do you adhere to it? What kind of factors influence the frequency?

How do you determine the frequency of future audits based on past audit findings?

How often do you do audits that include compliance?

Do audits cover the operations area, including all laws and regulations and applicable policy?

What were the findings of your last audit that included compliance?

Do you check to see that corrections to procedures are consistent with your audit findings?

What kind of sampling process did you use in your last audit?

Do your audits determine that no outdated forms and advertisements are used?

What kind of calculation equipment do you use to test Annual Percentage Rates?

What kind of a response did you get from the Board of Directors when you presented your findings?

Is your department adequately staffed to conduct thorough reviews for compliance?

Guidelines for External Interviews

In this appendix several suggestions are offered to facilitate conducting interviews external to the staff of the association being examined. The presentation is divided into two major segments: Interviews conducted for “information gathering,” and interviews conducted with complainants in response to protests or other formal complaints led against the association.

Information Gathering

When seeking factual information relevant to the examination of one or more institutions, the activity of data gathering must be handled discreetly. Although the examiner should identify his or her position, it is usually not necessary to identify an examination in progress at any specific association. A statement that data is needed for a general assessment of community trends (etc.) is usually sufficient.

Whenever possible, data gathering should be community-oriented, rather than institution-specific. For example, it is better to ask about the perceived marketing efforts of all, or a group of, financial institutions in a given community, with perhaps specific comment on each, than to simply ask how the marketing effort of First Savings Bank is viewed. If prescreening by real estate agents on behalf of one association is suspected, it is better to inquire about the loan solicitation practices of all or several lenders when talking to both sales agents and other community contacts.

Some outside contacts may be little more than a call to request prepared information. For example, obtaining a copy of a recent report by the Municipal Planning Commission. However, review of that information may lead to an interview with a Commission member. Other sources of data may be non-profit research agencies, colleges and universities, trade groups and professional organizations (e.g., the local Board of Realtors), and individuals in the community known to have the knowledge or contacts sought by the examiner. With regard to CRA assessments particularly, housing and small business coalitions, community activist groups and civil rights organizations may be willing to share their views on community developments.

A successful interview usually depends upon the preparation of the interviewer. The examiner should have some knowledge of the person or group to be interviewed, but most important, must have a firm grasp of his or her objectives in conducting the interview. Many interviewees will have their own agenda to pursue. The examiner must be alert to prevent a reversal of roles.

In contacting any outside sources, it is important that the examiner adhere to these principles:

- Do not misrepresent your professional or personal position;
- Be professional in speech, appearance and manner, as a representative of the OTS;
- Do not violate the rule of confidentiality by revealing privileged information concerning the OTS or about any supervised institution or its directors, officers, or staff; and
- Do not imply or promise any return favors or payment for information obtained. If there is a cost to obtain required data, this must be arranged through normal procurement channels.

Because the collection of outside data, through interviews or otherwise, can be quite time consuming, the examiner should attempt to make the result as broadly applicable as possible to all supervised institutions in the relevant market. Information should be maintained at the Regional Office for access by examiners assigned to other associations. This will minimize duplication of effort and unnecessary burden on the local sources.

FFIEC Short Course

The Federal Financial Institutions Examination Council offers a “home study” short course for financial institution examiners entitled, *Outside Contact Interviews ¾ Interviewing for Information from the Community*. The course, which consists of a VHS video tape and student workbook, focuses on basic interviewing strategy useful in the context of interviews to gather CRA, Fair Housing, and nondiscrimination information. Although the original course was packaged in the early 1980’s, the instruction provided remains relevant to interviews conducted today. Regulatory staff

interested in the availability of this course for their own use should contact their Regional Training Manager or Compliance Programs.

Complainant Interviews

An examiner may be asked by OTS management to perform an on-site investigation of a consumer's complaint. In addition to a review of association files and interviews with association personnel, it may be necessary to contact the complainant directly, either by telephone or in person. It is particularly important that complaints involving alleged discrimination on a prohibited basis be investigated immediately and thoroughly.

Before contact with the complainant is considered, the examiner should become familiar with the complaint, the association's initial response, and all relevant policies and procedures (articulated and actual) in effect at the association. If direct contact is still deemed necessary, an interview with the complainant may be scheduled. The examiner should emphasize that his or her role is to gather additional information and not adjudicate the complaint. Special care must be taken to avoid making statements that may seem to either defend or condemn the actions of the association or the complainant.

The following outline may be helpful in preparing for an interview involving a complaint of discrimination:

- *Basic data:* Obtain the complainant's name, address, telephone number and (to the extent relevant to the complaint) race, color, religion, national origin, sex, marital status, age and any other information of which the association had knowledge. The latter may include length of residency, occupation, place and length of employment, educational background, military status, size of family and amount and composition of income.
- *Financial data:* Determine the complainant's financial situation, for comparison with the data provided by the association in its response to the complaint. Obtain any information available about the complainant's ability and willingness to repay a debt, such as past credit history, judgments, bankruptcies, and delinquent accounts. Determine whether the complainant had dealt previously with the association and, if so, the history of those transactions.
- *Dealings between complainant and institution:* Obtain full details of all dealings between the complainant and the association or any agent of the association relevant to the complaint, including the names of persons dealt with and the dates of contacts. Obtain copies of any relevant documents in the complainant's possession. Ask the complainant to restate the basis for the complaint and to describe in detail the association's actions considered to be discriminatory.
- *Other financial arrangements:* If, since the date of the alleged discriminatory act, the complainant has made or attempted to make other financial arrangements for the same purpose for which the original loan was sought, determine the terms of such subsequent arrangements and with whom they were made. If possible, obtain a copy of any subsequent credit application approved by another financial institution.
- *Other action by the complainant:* Determine whether the complainant has led discrimination charges or complaints with any other federal, State, or local authority or agency or has retained legal counsel or other professional representation. If other actions have been initiated, ascertain the status of these actions.
- *Identity of potential complainants:* Ask the complainant whether he or she knows of other persons who allege to have encountered similar experiences. If possible, obtain their names and addresses. This will allow examination of related institutional records that may reveal a pattern of violations if prohibited practices have, in fact, occurred.
- *Closing the interview:* Cordially thank the complainant for his or her time and cooperation. Emphasize again that the role of the examiner is as a fact finder. Consistent with OTS guidelines, describe the steps remaining to reach a conclusion in response to the com-

plaint, but avoid committing to any specific outcome or response time.

Sampling Techniques

Several of the Handbook sections refer to the selection of a test sample. Unless specific directions are contained in a section for the size or method of sample selection to be followed, the general discussion of sampling in this subsection may be used to select an appropriate sample. In every case, the objective of sample selection is to provide reasonable confidence that the conclusions developed by the examiner are valid. If, in any situation, the examiner has significant doubt as to the validity of a conclusion, an expansion of the sample should be considered.

This appendix is divided into three major segments:

- A. Judgmental Sampling—General
- B. Sampling for Nondiscrimination
- C. Branch System Considerations

A. Judgmental Sampling—General

This general discussion is intended to apply primarily to judgmental sampling for other than nondiscrimination compliance. A separate discussion of sampling applicable to nondiscrimination issues is presented under Part B.

The feature that distinguishes judgmental from statistical sampling is that each item in the universe does not have an equal or random chance of being selected. Because a predetermined hypothesis is the subject of the test, selection is deliberately structured to build a sample populated with known examples of the attributes or characteristics being tested.

With statistical sampling, the objective is to form conclusions based on the sample that can be applied to the universe with a calculated level of confidence. Judgmental sampling does not support a statistically valid projection of sample results to the universe. Conclusions are valid only for the sample. Nevertheless, judgmental sampling is a valid means to test and confirm various hypotheses drawn from interviews, past experience or other

relevant sources about certain characteristics of all or part of the universe.

Judgmental sampling is useful for testing the anticipated effect of, or compliance with, a specific policy or procedure. The hypothesis to be tested may be either positive or negative. In other cases the hypothesis is based on the results of a statistical sample that revealed a possible weakness, but which was not conclusive. The examiner may use an expanded, judgmental sample to attempt to isolate the problem and to confirm an hypothesis as to its cause. A judgmental sample may also be useful to better quantify a known problem; for example, to estimate the dollar amount of reimbursable overcharges resulting from the actions of one loan officer who used faulty formulas.

Number of Samples

The number of judgmental samples to be taken depends on the circumstances at each association. The number of samples required will generally correspond to the number of hypotheses to be tested, although in some cases one sample can be used for a number of tests.

Sample Selection

There is no predetermined or established method for selecting a judgmental sample. The items selected should, of course, include the characteristic(s) being tested. However, when the test objective is to identify the cause of a specific characteristic, the selected items may have to be compared to items that are otherwise similar, but which do not include the test characteristic.

When defining the characteristics that will be subjected to testing, it is important to avoid defining the target population either too narrowly or too broadly. For example, in testing the calculation and disclosure of finance charges under Regulation Z, it will probably make sense to break credit transactions down by type (e.g., open end, closed end; then real estate, secured consumer loans, signature loans, etc.) Within a type, it may be useful to segregate further. Real estate loans may be divided into principal residence and other or fixed rate and adjustable rate.

If the association offers six different ARM programs with widely differing terms, it may be necessary to specifically sample each of the six programs. Alternatively, if all six ARM programs are identical except for, say, length of maturity and interest rate, and all are processed using one computer program, it may be sufficient to sample only two or three of the programs. Depending upon the association's administrative structure, it may be necessary to sample transactions based on which employee, department or branch office originated or processed the item. Certainly, if the initial sample reveals a problem that seems to correspond to an identifiable attribute of the affected transactions, further sampling of other transactions having that attribute is indicated. The focus of extended sampling should continue to narrow until the cause of the problem has been isolated.

Sample Size

Since statistical validity is not a key issue, the ideal size of a judgmental sample cannot be stated in terms of numbers. Enough items should be selected in order to draw a reasonable conclusion. Consequently, the examiner should balance the need to be reasonably certain that an hypothesis is correct against the need to move the examination forward.

When expanding an initial sample, either statistical or judgmental, using judgmental selection, expansion size is dictated by that necessary to finally confirm the examiner's hypothesis or to efficiently determine the cause or extent of noncompliance. However, discretion should be exercised. In some cases, the answers may be found by other means more efficient than selecting an expanded sample. The one loan officer using a faulty formula, once identified, may be able to provide detailed records of all his transactions, precluding the need to pull additional loan files. If a substantial increase in sampling effort is foreseen, the effect of this increase on total examination time should be discussed by the EIC with a supervisor.

B. Sampling for Nondiscrimination

In examining for the presence of illegal discrimination, the "norm" is not a succinct external standard or condition against which selected sample items can be tested, as is the case with the technical re-

quirements of the regulations. Rather, discrimination testing requires that loans applied for or granted to certain groups of customers be compared against the loans applied for or granted to other groups of customers. Review of a single group of loans selected at random, while capable of raising questions about apparent disparate treatment patterns suggested in that sample or about policies possibly discriminatory in effect, cannot be relied upon to yield definitive conclusions about most discrimination issues.

Proving or disproving the presence of credit discrimination is a process of judgmental sampling and hypothesis testing. Transactions involving each protected group to be considered must be specifically identified and segregated, each group represented by a unique universe. When a selected universe is too large to permit review of each transaction, then statistical sampling techniques may be used to select out a test population.

In conjunction with identifying the judgmental samples involving protected classes of customers, the examiner begins building various hypotheses. These can be based on information obtained during review of lending policies and procedures or from any other source available to the examiner. Generally, an hypothesis will be in the form of a statement to be proved or disproved based on data found in the loan files comprising the sample. Three examples of hypothesis tests are presented to illustrate:

- *Hypothesis:* "Underwriting requirement X is strictly applied to minority borrowers, but is often waived for white borrowers." A review of the loan files for black and Hispanic borrowers and for white borrowers reveals that in 18 out of 20 minority loans (90%) requirement X was imposed, but the same requirement was imposed on only five out of 45 loans (11%) to whites. This hypothesis, which developed because the examiner considered requirement X, as stated in the institution's lending policy, highly restrictive if applied to the "average" applicant, is proved out by the sample.
- *Hypothesis:* "Single female applicants are more frequently rejected for failure to provide a cosigner than are single male applicants of

comparable credit worthiness.” A review of rejected and approved applications from single women and from single men reveals that only four out of 34 female applicants were rejected for failure to provide a cosigner (12%) compared to 15 out of 77 male applicants (19%) rejected on the same basis. However, a second look reveals that 18 of the 34 female applicants (53%) were required to produce a cosigner, compared to 21 of the 77 male applicants (27%).

In this case the original hypothesis, generated on the basis of complaint letters from two of the rejected female applicants, was not supported by the sample. But the original hypothesis was off target in focusing on only rejected applications. Instead the examiner should have been looking at the underlying policy for requiring cosigners, which the association was not applying uniformly. Fortunately, by drawing a sample of both rejected and accepted applications, the examiner identified the discriminatory practice.

- *Hypothesis:* “The association does not set different maximum term and loan-to-value requirements for residential mortgage loans based on the average age of the housing stock in the borrower’s neighborhood.” Based on local housing data keyed to ZIP codes provided by the institution, the examiner compares terms approved for loans secured by houses 20 to 25 years old located in neighborhoods with an average housing stock age of 35 years with similarly aged security properties in neighborhoods with an average housing stock age of 15 years. Adjusting for variations in applicant credit risk and other variables unique to each loan, the examiner determines no discernible correlation between average age of the housing stock and approved loan terms.

This hypothesis was developed on the basis of management’s response to a housing advocate’s claim that the association based its loan terms on the age of the neighborhood housing stock, which was discriminatory in effect since the older neighborhoods were predominately minority. In this case, the hypothesis, and

management’s response, was supported by the judgmental sample.

In situations where the sample data supports an hypothesis that illegal discrimination has occurred, the association should be given an opportunity to show bona fide, nondiscriminatory reasons for the results. Factors not yet considered by the examiner may be determinative.

Sampling for credit discrimination in a branch office environment raises unique problems, especially in highly decentralized branch networks. To test for discrimination without introducing erroneous assumptions, the examiner must consider the location of the branch originating the credits or receiving the applications. A branch in an integrated area affords the most convenient opportunity to compare treatment of minority and non-minority applicants within a single branch. However, to identify subtle differences in underwriting requirements or available credit products between branches serving predominately minority and predominately non-minority markets, policies, procedures and test samples must be compared between branches.

While location may account for differences in the relative numbers of customers from various protected groups between branches, the differences should reasonably reflect actual composition of the community’s population. Underwriting standards and available credit products should not vary between branches in a way that adversely affects the opportunities of protected groups. Additional information regarding sampling in a branch environment appears under the next heading.

C. Branch System Considerations

Branch systems pose special sampling problems. The organization and operational flow existing for the particular items under investigation will determine the procedures to be followed. Special consideration should be given to branch visits when examining for credit discrimination and CRA compliance. It is important to include in the examination those branches which serve low- and moderate-income neighborhoods, and branches whose “communities” are populated by racial minorities. The principal types of operational ar-

rangements and their respective procedural considerations follow.

Centralized Recordkeeping

When all branch operations for the relevant lending function are closely regulated by the head office and when all loan records and files for the association are centralized in that one location, the appropriate universe for drawing samples would be the head office files. The sample should be selected with care to avoid a concentration in loans originated at only a few branches. This may require supplementing a random statistical sample with a judgmental sample if the original sample contains an insufficient number of items from one or more branches to form reasonable conclusions about performance at the under-represented branch(s).

An on-site examination at selected branches would focus mainly on ascertaining the level of branch understanding of and compliance with head office policies and procedures, the nature of any branch prescreening activities, the attitudes of branch personnel, and other indicators of compliance that require first-hand observation. Such on-site examinations should be considered for all major branches; for example, branches generating 20 percent or more of the association's total volume of a particular category of loans. A random selection of smaller branches should be checked on a rotating basis such that all branches can be covered over a six-year period.

Regional Processing Centers

When branch operations for the target loan category are administered through regional processing centers, each center should be examined in the same manner as the head office with regard to all regional operations. This will generally require conducting a "streamlined" version of the compliance examination. The universe for drawing samples would be the activity processed at that center. In addition, a spot-check of branch office operations is still required along the lines indicated in the previous paragraphs.

Decentralized Loan Administration

When the branch system has a decentralized loan administration, with each branch processing its own loans and retaining all its own records, the examination procedure should focus more extensively on the operations of individual branches. The nature and extent of individual branch coverage will, however, depend upon the degree of head office control over branch policies and procedures.

In situations where the head office sets standard operating policies and procedures, and has an aggressive internal monitoring and enforcement program to ensure branch compliance, it may be sufficient to treat the branch network as a centralized operation by concentrating on the internal compliance program. However, spot-checks at selected branches will still be necessary, following the method outlined under Centralized Recordkeeping, above.

If observation shows that branches operate with considerable independence, that standardization of forms, policies and procedures does not exist, or that head office enforcement of standards is lax, then each branch examined must be treated essentially as a separate institution. This will call for a detailed review of the forms, policies, and procedures at each selected branch, followed by an adequate sampling of branch activity, with each branch treated as a separate universe. Under these highly decentralized branch operations, each examination should include all major branches, plus a rotating sample of other branches such that all branches are examined at no more than four-year intervals.